Decision **DRAFT DECISION OF ALJ WONG** **(Mailed 6/25/2003)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company Regarding Year Seven (2000-2001) Under Its Experimental Gas Cost Incentive Mechanism and Related Gas Supply Matters. (U 904 G)	Application 01-06-027 (Filed June 15, 2001)

OPINION REGARDING YEAR SEVEN OF THE GAS COST INCENTIVE MECHANISM

Summary

Today's decision addresses the Year Seven Gas Cost Incentive Mechanism (GCIM) application filed by Southern California Gas Company (SoCalGas) on June 15, 2001.

The decision finds that SoCalGas reasonably managed its gas acquisitions and operations in Year Seven within the context of the GCIM that existed at the time, and that the calculation and amount of the shareholder award is correct. Pursuant to Decision (D.) 02-06-023, SoCalGas is awarded a shareholder award of $30,826,587 for Year Seven.

Due to the ongoing activities in the Order Instituting Investigation (I. or investigation) 02-11-040, the finding of reasonable management shall not prejudge what the Commission may find or conclude in I.02-11-040, and the SoCalGas shareholder award shall be subject to refund or adjustment as may be determined by the Commission in I.02-11-040.

Procedural and Factual Background

The GCIM is a ratemaking mechanism that SoCalGas uses to purchase natural gas on behalf of its core customers. SoCalGas was first authorized to use the GCIM in D.94-03-076 [53 CPUC2d 663]. Most recently, in D.02-06-023, the GCIM was modified and SoCalGas was authorized to continue the use of the GCIM on an annual basis until modified or terminated by the Commission. SoCalGas' application describes the results of operations under the GCIM structure for its gas acquisition activities for Year Seven, the period from April 1, 2000 through March 31, 2001.

On June 15, 2001, SoCalGas filed its Year Seven GCIM application. A joint protest was filed by Southern California Edison Company (SCE) and the Southern California Generation Coalition (SCGC) on July 19, 2001. Another protest to the application was filed by the California Industrial Group and the California Manufacturers & Technology Association (CIG/CMTA). The Office of Ratepayer Advocates (ORA) filed a response to the application on July 19, 2001. SoCalGas filed a reply on July 30, 2001 to the protests and to ORA's response.

On November 2, 2001, ORA served its Monitoring and Evaluation Report on the Year Seven GCIM.

Two prehearing conferences were held on October 29, 2001 and November 6, 2002 to discuss whether the issues raised by the protestants should be examined in this application or elsewhere, and to determine the procedural schedule for processing this application. When the first prehearing conference was held in October 2001, a proposed settlement in Phase II of SoCalGas Year Six GCIM, A.00-06-023, was still pending. The proposed settlement addressed certain modifications to the GCIM, and proposed to reduce the shareholder award for Year Seven from $106 million to $30.8 million. Due to the uncertainty of whether the proposed settlement would be adopted and the impact on the Year Seven proceeding, the administrative law judge (ALJ) indicated that another prehearing conference should be held after the Commission considered the proposed settlement.

After two days of evidentiary hearings and the submission of briefs, the proposed settlement and the Phase II issues in A.00-06-023 were resolved in D.02-06-023. D.02-06-023 approved the settlement agreement. The approval of the settlement agreement resulted in a reduction of the shareholder award for Year Seven to $30.8 million, and continuation of the GCIM as modified by the terms of the settlement. D.02-06-023 also directed the Energy Division to prepare an investigation into the gas border price spikes that occurred during the winter of 2000 through spring 2001.

The second prehearing conference was held on November 6, 2002. At that prehearing conference, the ALJ mentioned that the Commission was considering opening an investigation into the gas border price spikes at its November 7, 2002 business meeting, and that the investigation could possibly be the forum for addressing protestants' concerns about the GCIM structure. On November 21, 2002, the Commission adopted I.02-11-040, initiating its investigation into the possible causes of high gas border prices for the period March 2000 through May 2001.

On January 16, 2003, the scoping memo and ruling was issued for this proceeding.[1] The scoping memo and ruling described D.02-06-023 and I.02-11-040, and stated:

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[1] A revised scoping memo and ruling was issued on March 18, 2003, and a further revised scoping memo and ruling was issued on May 21, 2003.

> Based on the actions taken in D.02-06-023 and I.02-11-040, the issues raised by SCE, SCGC and CIG/CMTA in their protests to this application have either been resolved in D.02-06-023, or will be addressed in I.02-11-040. As a result, there are only two remaining issues that need to be addressed in this proceeding. The first issue is whether the calculation of the shareholder award for Year Seven under the GCIM, as modified by D.02-06-023, is correct or not. The second issue is whether SoCalGas' acquisition operations during Year Seven were reasonable within the context of the authorized GCIM.
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> As noted at the November 6, 2002 prehearing conference, the first issue is straightforward, and is derived by examining ORA's Monitoring and Evaluation Report dated November 2, 2001. No one contests the way in which the shareholder award was calculated for Year Seven.
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> The second issue is also addressed in ORA's November 2, 2001 report. Although SCE, SCGC and CIG/CMTA have raised concerns about the way in which the GCIM is structured, and whether SoCalGas' operations amounted to market power, anticompetitive behavior, or was a cause of the high gas prices experienced in later 2000 through spring 2001, both D.02-06-023 and I.02-11-040 have either addressed those concerns or will provide a forum for addressing those concerns. Consequently, the second issue can be addressed without waiting for I.02-11-040 to be resolved.

The scoping memo and ruling also determined that no evidentiary hearings would be held because no one disputes how SoCalGas' shareholder award was calculated, and because the protestants' concerns will be addressed in I.02-11-040.

Position of the Parties

A. SoCalGas

The Year Seven GCIM application of SoCalGas reports on the reasonableness of its gas supply and storage operations for the period April 1, 2000 through March 31, 2001. In accordance with D.94-03-076, D.97-06-061 and D.98-12-057, SoCalGas requests that the Commission approve a shareholder award of $106.1 million. However, if the settlement agreement in Phase II of A.00-06-023 is approved by the Commission, SoCalGas has agreed to reduce the shareholder award to $30.8 million for Year Seven.[2]

SoCalGas' Annual Report for Year Seven, which was attached to SoCalGas' application, states:

> "In summary, the GCIM provides an incentive for Gas Acquisition to efficiently use retail core's interstate pipeline and storage rights to deliver reliable, low-cost supplies. Reliability is achieved by constructing a portfolio of natural gas supplies that is diversified by contract type, geographic region, and supplier. Gas Acquisition uses tools available to a typical trading organization, including purchases, sales, loans, parks, wheels, derivatives, exchanges, and transportation contracts. These tools enhance reliability and allow Gas Acquisition to make economic use of assets, when not needed for reliability, to help lower gas costs." (A.01-06-027 Application, Ex. D, p. 6.)

In addition to the Commission approving the appropriate shareholder award, SoCalGas recommends that the Commission find that SoCalGas' operations were consistent with Commission standards in effect for Year Seven.

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[2] When SoCalGas filed its Year Seven application, the settlement agreement had not yet been approved by the Commission.

SoCalGas also recommends that the Commission approve the extension of the GCIM on an annual basis into Year Eight and beyond, or until the Commission approves a request to modify or terminate the GCIM.

B. SCE and SCGC

SCE and SCGC contend that SoCalGas has not been authorized to use the GCIM for Year Seven or any year thereafter, and therefore it is not entitled to any award for Year Seven. However, if the GCIM applies to Year Seven, SCE and SCGC assert that hearings are needed to develop a record on the reasonableness of the GCIM structure and the reasonableness of the Year Seven award that SoCalGas is requesting.

SCE and SCGC contend that the GCIM structure requires modification because it contains "perverse incentives … that causes SoCalGas to conduct operations in a ways to benefit its shareholders at the expense of customers." (SCE and SCGC Protest, p. 2.) SCE and SCGC believe the hub services used by SoCalGas during Year Seven had a negative effect on SoCalGas' customers, and that the actions were largely motivated by SoCalGas seeking a higher shareholder award at the expense of gas and electric ratepayers.

SCE and SCGC acknowledge in their protest that although "the amount of the Year Seven GCIM award and the structure of the GCIM is the subject of a settlement filed in SoCalGas' Year Six GCIM Phase II proceeding, the Protestants believe that these issues will have to be revisited in the Year Seven proceeding because of the need for the record evidence that will be developed as part of the Year Seven proceeding." (SCE and SCGC Protest, p. 3.)

C. CIG/CMTA

CIG/CMTA contend that the Commission deferred judgment on whether the operation of the GCIM should be extended beyond Year Six. They also assert that the GCIM may provide inappropriate gas procurement incentives that may distort the marketplace. CIG/CMTA also assert that the shareholder compensation that SoCalGas is requesting produces unjust and unreasonable results when viewed in the context of the Year Seven market conditions.

CIG/CMTA states that it "is particularly concerned that the GCIM may have contributed significantly to the problem of disproportionately high California border prices." (CIG/CMTA Protest, p. 3.) CIG/CMTA urge the Commission to hold hearings on SoCalGas' application to determine whether the GCIM provided inappropriate incentives to SoCalGas and whether that contributed to the price differential between border prices and basin prices.

CIG/CMTA also argue that the settlement in Phase II of A.00-06-023 would deprive the parties of an opportunity to examine the GCIM in light of the Year Seven data.

CIG/CMTA contend that if the GCIM is to be continued, the Commission "must ensure that the mechanism provides appropriate incentives for SoCalGas procurement as well as reasonable end results." (CIG/CMTA Protest, p. 2.) If appropriate incentives are not created, CIG/CMTA assert that "SoCalGas customers will be disserved and the natural gas marketplace may be needlessly distorted." (Id.)

D. ORA

ORA states that in D.00-06-039, the Commission ordered its staff to evaluate the GCIM before January 1, 2001, and deferred judgment on whether the GCIM should be extended into Year Seven until the ORA report was completed. The report was issued on January 4, 2001. In D.01-05-002, the second phase of A.00-06-023 was established to consider whether modifications to the GCIM are required.

ORA's Monitoring and Evaluation Report for Year Seven was served on November 2, 2001. This report states that ORA "conducted a comprehensive review, audit, and evaluation of the GCIM Year 7 results submitted by SoCalGas in its application." (ORA Monitoring and Evaluation Report, Nov. 2, 2001, p. 1-2.) The report also states that the cost savings below the GCIM benchmark were confirmed, and that the shareholder award amount of $106.1 million was verified. ORA's report recommended, however, that the shareholder award be limited to $30.8 million, consistent with the settlement agreement in A.00-06-023.[3]

Discussion

The GCIM is the structure which replaced the Commission's reasonableness reviews of SoCalGas' gas purchases and gas storage decisions on behalf of its core sales customers.[4] The GCIM is designed to provide SoCalGas with a financial incentive for making efficient gas purchasing decisions. The incentive is created by establishing a benchmark against which SoCalGas' gas supply purchases for its core and core subscription customers are measured. The benchmark is based on a combination of monthly gas price indices.

SoCalGas' Year Seven application states that it was able to purchase gas at $223.6 million below the GCIM benchmark. The actual cost of all the purchases subject to the GCIM was $2.1875 billion, and the benchmark cost was $2.411 billion. As established in D.97-06-061, the savings from purchases below

[3] ORA recommended that even if the settlement agreement in A.00-06-023 is not adopted by the Commission, that SoCalGas' shareholder award should still be limited to $30.8 million.

[4] Prior to D.94-03-076, the Commission reviewed SoCalGas' gas purchases and operations in annual reasonableness reviews. (See 53 CPUC2d at p. 665.)

the benchmark lower tolerance band ($212.2 million) are to be shared equally between SoCalGas and its customers. Accordingly, SoCalGas requests a shareholder award of 50 percent of the $212.2 million in savings, or $106.1 million.

However, the Year Seven application notes that the settlement in Phase II of the Year Six proceeding would modify the GCIM and retroactively apply to Year Seven. SoCalGas notes that if the settlement is adopted, this would reduce the shareholder award from $106.1 million to $30.8 million. The $30.8 million amount reflects the settlement agreement's provision that caps the shareholder award to 1.5% of the actual annual gas commodity cost.

ORA conducted a review, audit, and evaluation of the Year Seven GCIM results, which is contained in ORA's November 2, 2001 Monitoring and Evaluation Report for Year Seven. This analysis confirmed the gas volumes purchased, storage and gas sales, hedging activities, the benchmark price, volumetric interstate transportation costs, interstate reservation costs, and the capacity levels nominated and the actual volumes delivered by pipeline. In summary, ORA's analysis verified the following:

- The Year Seven GCIM resulted in total savings of $223,571,953 based on the difference between the actual cost of gas of $2,187,533,957 and the benchmark index of $2,411,105,910.

- The total savings were comprised of shared savings of $212,176,724 and $11,395,229 associated with the 0.5% lower tolerance band.

- Under the GCIM as modified by D.97-06-061, ratepayers and SoCalGas shareholders would each receive a benefit of $106,088,362 associated with the shared savings, and the entire lower tolerance band savings of $11,395,229 would flow to ratepayers.

- If the settlement in Phase II of A.00-06-023 is adopted, the Year Seven GCIM will reduce the shareholder award from $106,088,362 to $30,826,587 and the ratepayer benefit will increase from $117,483,591 to $192,745,366.

We first address the concerns raised by the protestants to SoCalGas' application. At the two prehearing conferences, the issues raised by the protestants were recognized, and the ALJ discussed how these issues were being addressed in Phase II of A.00-06-023 and in the investigation the Commission was considering opening. Following the adoption of the settlement in D.02-06-023, and the opening of the investigation into the cause of gas border price spikes, the January 16, 2003 scoping memo and ruling was issued. The scoping memo and ruling recognized that after evidentiary hearings, D.02-06-023 resolved the issues of whether the GCIM structure should be extended for Year Seven and beyond, and whether the GCIM should be modified. The Commission also declined in D.02-06-023 to consider another investigation of the GCIM.

The scoping memo and ruling also noted that I.02-11-040 opened an investigation into the cause of gas border price spikes. Among the issues that the investigation will look at are whether the utilities' affiliates or parent companies' financial positions caused the utilities to take actions that may have increased gas costs, and whether the GCIM created perverse incentives to increase or manipulate gas prices at the California border, and whether the GCIM enables the utilities to exercise market power or anticompetitive behavior. The scoping memo and ruling also stated that based on D.02-06-023 and I.02-11-040, the issues raised by SCE, SCGC and CIG / CMTA were either resolved in D.02-06-023 or will be addressed in I.02-11-040.

Thus, there are only two remaining issues that need to be addressed in this proceeding. The first issue is whether the calculation of the shareholder award for Year Seven under the GCIM structure, as modified by D.02-06-023 is correct or not. The second issue is whether SoCalGas' acquisition operations during Year Seven were reasonable within the context of the authorized GCIM.

With regard to the first issue, none of the protestants dispute the calculation of SoCalGas' request for a shareholder award of $106.1 million for Year Seven, or the reduced amount of $30.8 million. Although the protestants have raised concerns about the GCIM structure, those concerns are being addressed by the Commission in I.02-11-040 or have been addressed in D.02-06-023. ORA's Monitoring and Evaluation Report has verified that these amounts and the calculation of the shareholder award amounts for Year Seven are correct.

The second issue is whether SoCalGas' acquisition operations during Year Seven were reasonable within the context of the authorized GCIM. Although the protestants have raised concerns about the GCIM structure and whether it creates perverse incentives, again, those concerns are to be examined in I.02-11-040. If the investigation reveals that the respondents' conduct contributed to the gas price spikes at the California border during the time period of the investigation, I.02-11-040 states that the Commission may modify or eliminate the GCIM, reduce the amount of the shareholder award for the period involved, or order the respondents to issue a refund to ratepayers to offset the higher rates that were paid.

ORA's Monitoring and Evaluation Report for Year Seven analyzed and evaluated the reasonableness of SoCalGas' gas operations for the period. ORA's report for Year Seven "concludes that the GCIM continues to provide favorable benefits to SoCalGas' natural gas procurement customers." (ORA Monitoring and Evaluation Report, p. 1-3.) Although natural gas prices rose in Year Seven to levels never before experienced, ORA states that "SoCalGas did an effective job of managing its overall gas procurement costs and core procurement prices." (Id.) ORA also states that the GCIM allowed SoCalGas to effectively manage its procurement costs during this period, and allowed SoCalGas to cushion the impact of the volatile gas prices on its customers. ORA also states that it "is thoroughly convinced that the GCIM is the single most important factor in allowing SoCalGas to effectively manage its gas procurement costs and ultimately achieve significant cost savings during extremely volatile market conditions." (Id., at p. 1-4.)

After reviewing SoCalGas' application and ORA's Monitoring and Evaluation Report for Year Seven, we find that SoCalGas reasonably managed its gas acquisitions and operations in Year Seven within the context of the GCIM that existed at the time. Since the Commission is conducting an investigation into the causes of high gas border prices from March 2000 through May 2001, today's finding does not prejudge what the Commission may find or conclude in I.02-11-040.

We also find that the calculation and amount of SoCalGas' shareholder award for Year Seven, both unmodified and as modified by D.02-06-023, are correct. In accordance with the settlement agreement and GCIM modifications adopted in D.02-06-023, SoCalGas is entitled to a shareholder award of $30,826,587 for Year Seven of the GCIM. However, due to the ongoing activities in I.02-11-040, the Commission may adjust the shareholder award for Year Seven if that investigation reveals that the conduct of the respondents to the investigation contributed to the price spikes at the California border during the investigation's time period. Thus, we will award SoCalGas a shareholder award of $30,826,587 for Year Seven of its GCIM, subject however to refund or adjustment, as may be determined in I.02-11-040. SoCalGas is permitted to adjust the Purchased Gas Account to reflect the shareholder award that may be subject to refund or adjustment.

Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Public Utilities Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments on the draft decision were filed on __________ and reply comments were filed on ________.

Assignment of Proceeding

Loretta M. Lynch is the Assigned Commissioner and John S. Wong is the assigned ALJ in this proceeding.

Findings of Fact

1. D.02-06-023 approved the settlement agreement in Phase II of A.00-06-023, which reduced the shareholder award for Year Seven to $30.8 million, and continued the GCIM as modified by the terms of the settlement.

2. D.02-06-023 determined that the objections that SCE raised in the Phase II hearings regarding the GCIM were speculative and not supported by the evidence, and that another investigation of the GCIM was unnecessary.

3. D.02-06-023 directed the Energy Division to prepare an investigation into the gas border price spikes that occurred during the winter of 2000 through spring 2001.

4. The Commission adopted I.02-11-040 on November 21, 2002, which opened an investigation into the possible causes of high gas border prices.

5. The scoping memo and ruling in this proceeding, issued on January 16, 2003, described what had occurred in D.02-06-023 and I.02-11-040, and ruled that no hearings would be held in this proceeding.

6. The GCIM is designed to provide SoCalGas with a financial incentive for making efficient gas purchasing decisions.

7. SoCalGas acquired gas at a savings of approximately $223.6 million below the GCIM benchmark in Year Seven.

8. Under the GCIM formula, as modified by D.97-06-061, there is a shareholder award of $106,088,362.

9. Under the settlement agreement in Phase II of A.00-06-023, the shareholder award would be reduced from $106,088,362 to $30,826,587.

10. None of the protestants dispute the calculation of the shareholder award of $106.1 million for Year Seven, or the reduced amount of $30.8 million.

11. The protestants' concerns about the GCIM structure have been addressed in D.02-06-023 or will be addressed by the Commission in I.02-11-040.

12. ORA's Monitoring and Evaluation Report for Year Seven verified the amounts and calculation of the shareholder award.

13. I.02-11-040 states that the Commission may modify or eliminate the GCIM, reduce the amount of the shareholder award for the period involved, or order the respondents to issue a refund to ratepayers.

14. ORA's Monitoring and Evaluation Report for Year Seven analyzed and evaluated the reasonableness of SoCalGas' gas operations for the period.

15. SoCalGas reasonably managed its gas acquisitions and operations in Year Seven within the context of the GCIM that existed at the time.

16. The calculation and amount of SoCalGas' shareholder award for Year Seven are correct.

Conclusions of Law

1. Today's finding regarding the reasonableness of SoCalGas' management of its gas acquisitions and operations in Year Seven shall not prejudge what the Commission may find or conclude in I.02-11-040.

2. In accordance with the settlement agreement and GCIM modifications adopted in D.02-06-023, SoCalGas is entitled to a shareholder award of $30,826,587 for Year Seven of the GCIM.

3. Due to ongoing activities in I.02-11-040, the Commission may adjust the shareholder award for Year Seven if that investigation reveals that the conduct of the respondents in Phase I to the investigation contributed to the price spikes at the California border.

4. SoCalGas should be awarded a shareholder award of $30,826,587 for Year Seven of its GCIM, subject however to refund or adjustment, as may be determined in I.02-11-040.

5. SoCalGas should be permitted to adjust the Purchased Gas Account to reflect the shareholder award of $30,826,587 that may be subject to refund or adjustment.

6. This order should be effective today in order to resolve this matter expeditiously.

O R D E R

IT IS ORDERED that:

1. Southern California Gas Company (SoCalGas) is authorized to adjust the Purchased Gas Account to recognize a shareholder award of $30,826,587 under Year Seven of its Gas Cost Incentive Mechanism.

2. SoCalGas' shareholder award amount of $30,826,587 shall be subject to refund or adjustment as may be determined by the Commission in Order Instituting Investigation 02-11-040.

3. This proceeding is closed.

This order is effective today.

Dated ____________________________, at San Francisco, California.